

AICPA Investment Companies Expert Panel Frequently Asked Questions Regarding the SEC's Revised Custody Rule¹ and Guidance for Accountants²

The following summary and frequently asked questions (FAQs) about the SEC's Revised Custody Rule were developed by the AICPA Investment Companies Expert Panel based on a review of the Custody Rule, the Adopting Release, the SEC staff FAQs posted on the SEC's website (see below), and discussions with the SEC staff. These notes do not necessarily reflect the views of the AICPA, the SEC, or the SEC staff. The expert panel is not authorized to make public statements on behalf of AICPA without clearance from AICPA Council or the Board of Directors on such matters.

The staff of the Division of Investment Management has prepared responses to questions about the rule 206(4)-2, the "custody rule" under the Investment Advisers Act of 1940. They can be viewed at http://sec.gov/divisions/investment/custody_faq_030510.htm. For official SEC responses to accounting and financial reporting questions for SEC-Registered Investment Advisers, please contact the SEC Office of Chief Accountant, Division of Investment Management, by calling (202) 551-6918 or E-mail: IMOCA@sec.gov.

The SEC staff issued a FAQ on March 5, 2010, which has been, and will be, amended from time to time, and can be found on the SEC's website at http://www.sec.gov/divisions/investment/custody_faq_030510.htm. Some of the questions discussed herein have been addressed by this FAQ.

Custody is defined in the rule and custody does not equate to serving as a qualified custodian (QC) which is also defined under the rule.

The rule provides, among other things, four basic customer protections when a registered investment adviser (RIA) has custody under the rule:

1. Requirement to maintain funds and securities with a qualified custodian in a separate account for each client under that client's name; or in accounts that contain only clients' funds and securities, under the investment adviser's name as agent or trustee for the clients;
2. Requirement that clients are notified promptly in writing of the qualified custodian's name, address, and the manner in which the funds or securities are maintained, when an account is opened by an investment adviser on a client's behalf and following any changes to this information;
3. Requirement that the investment adviser has a reasonable basis, after due inquiry, for believing that the qualified custodian sends an account statement, at least quarterly, to each of its clients for which it maintains funds or securities, identifying the amount of

¹ See *Custody of Funds or Securities of Clients by Investment Advisers*; Rel. No. IA-2968.
<http://sec.gov/rules/final/2009/ia-2968.pdf>.

² See *Commission Guidance Regarding Independent Public Accountant Engagements Performed Pursuant to Rule 206(4)-2 Under the Investment Advisers Act of 1940*; Rel. No. IA-2969.
<http://sec.gov/rules/final/2009/ia-2969.pdf>.

funds and of each security in the account at the end of the period and setting forth all transactions in the account during that period; and

4. Requirement for an independent verification (surprise exam) on an annual basis.

The rule also provides an enhanced protection when a RIA has self-custody³ or custody by a related person to comply with the 4 protections noted above, which includes: (1) the accountant engaged to perform a surprise examination must be registered with, and subject to regular inspection by, the PCAOB and (2) the adviser must obtain or receive from the related person an internal control (IC) report that addresses the safekeeping of client assets at the qualified custodian (QC). An accountant for this internal control report engagement must be registered with, and subject to regular inspection by, the PCAOB.

Qualified custodian internal control report requirement is result of an adviser serving as a qualified custodian or its related person serving as a qualified custodian.

Exceptions to the rule:

1. From surprise exam for those advisers:
 - a. that have custody of funds and securities solely because of their authority of being able to deduct advisory fees
 - b. that have custody of funds and securities solely because of a related person that is operationally independent, as defined by the rule, has custody
2. For adviser to the pooled investment vehicle (this exception is now called “audit provision”):
 - a. the adviser would be deemed to comply with the surprise examination and is not required to comply with the notice and account statements requirements as long as audited financial statements are prepared in accordance with US GAAP and distributed to the investors within 120 days, and for FOFs, distributed to the investors within 180 days;
 - b. the accountant performing the audit of a pooled investment vehicle must be registered with, and subject to regular inspection by, the PCAOB;
 - c. upon liquidation, the financial statements need to be distributed promptly upon completion of the audit
3. Privately offered securities – if a security meets the definition of a privately offered security under the rule, that security then is not required to be held by a QC; exception to this exception – if a pooled investment vehicle is not relying on the “audit provision,” to the extent it holds privately offered securities, those securities must be held by a QC.
4. Investment advisers to SEC registered investment companies are not required to comply with 206(4)-2 with regard to the accounts of a registered company

³ Under the rule an adviser is deemed to have self custody if it also serves as the qualified custodian for its clients.

that they manage, because registered companies are subject to the custody requirements of section 17(f) of the Investment Company Act.

5. Further, where the adviser invests client assets in shares of SEC registered open-end funds (that he/she does not manage), the adviser may use the fund's transfer agent in lieu of a qualified custodian.

Compliance dates:

- Effective date of the amendment is March 12, 2010, subject to certain exceptions:
 - First surprise exam – an investment adviser required to obtain a surprise examination must enter into a written agreement with an independent public accountant that provides that the examination will take place by December 31, 2010;
 - For those advisers that became subject to the rule after the effective date, first surprise exam shall take place within 6 months of becoming subject to the rule;
 - RIAs that maintain client assets as a QC (self-custody situation when the IA is also a broker-dealer) – first surprise exam would have to take place no later than 6 months after obtaining an IC report;
 - IC report– an adviser must obtain or receive an IC report within 6 months after becoming subject to the rule (for advisers that were registered at the time when the rule became effective, by September 12, 2010).
- For audits of pooled investment vehicles – they can rely on “audit provision” as long as an adviser is contractually obligated to obtain an audit for fiscal years beginning on or after January 1 2010; an accountant must be registered with, and subject to regular inspection by, the PCAOB. As per Question I.5 of the FAQ, the obligation to obtain an audit may be evidenced in a partnership agreement, disclosure statement, or engagement letter with the auditor. See footnote 47 of the 2003 custody rule adopting release at http://sec.gov/rules/final/ia-2176.htm#P127_38487.

Questions and answers prepared by the AICPA Investment Companies Expert Panel:

1. In a number of cases, broker/dealers are dually registered as investment advisers.
 - a. In these instances, would the broker/dealer be a self-custodian rather than an "affiliated" custodian, and thus be required to have both a controls examination and a surprise examination? Or could the custody operations be considered "operationally independent" even though they are part of the same legal entity so long as they meet all the other conditions for independence (i.e., separate organization, personnel and facilities)?

This is a legal determination that should not be made by accountants but rather by an adviser in conjunction with its legal counsel. However, dual registrants ordinarily would be subject to both the surprise exam and internal control report, as (being the same entity) they could not be considered operationally independent.

- b. Page 3 of the adopting release states that the Commission intends to review "potential recommendations to enhance the oversight of broker-dealer custody of customer assets" and that "consideration of additional enhancements.....[will] follow." How will the broker-dealer rules be integrated with this rule to avoid multiple requirements to address the same concerns for dually registered entities? **As the question relates to future rule-making, it cannot be answered at this time.**
- c. If a broker-dealer (or FCM) is in scope, how will surprise examination procedures contemplate the entire stock record balance (e.g., firm inventory, including repos and stock borrow/loan positions), and how would samples be selected?
 - **IC report works with the surprise exam. The auditor should be able to place reliance on the procedures performed in the internal control report when performing the surprise exam (e.g., testing performed on the stock record). Some substantive procedures are already identified in the interpretive guidance, such as requirement to confirm with custodians to verify the existence of funds and securities at unaffiliated entities or unaffiliated custodians may be more appropriately addressed in performing the controls examination.**
 - **As far as the procedures concerning issuance of the IC report, auditors can leverage work performed in connection with other regulatory requirements (such as required regulatory reports on B/D custody) in the current financial statement audit.**

- **Confirmations are not specifically mandated as part of the rule requirement to verify that funds and securities are reconciled to a custodian other than the adviser or its related person. Pursuant to the Guidance for Accountants (see Release No. IA-2969), while direct confirmation with an unrelated custodian would be acceptable, accountants are permitted to perform other procedures designed to verify that the data used in reconciliations performed by the qualified custodian is obtained from unaffiliated custodians and is unaltered; for example, obtaining comfort with the completeness and authenticity of the custodian's data flow with DTC which the custodian uses to reconcile securities to DTC may be an appropriate procedure.**
 - **If a related party B/D QC has received an internal control report, an auditor would still need to reconcile the adviser's separate books and records to the B/D QC's books and records in a surprise examination but would not need to re-confirm positions with DTC or other third parties as part of that examination.**
 - **There is no prescriptive guidance regarding sample size selection; however, SAS 70 and attest literature for sampling will apply. Choosing the sample size is a matter of professional judgment.**
2. SAS 70/AT 601 reports - the adopting release and companion interpretation indicate a number of specific control objectives to be present in the internal control reports.
- a. Must each control objective be stated as specified or is there some discretion to tailor to the specific control environment of the qualified custodian? (For example, it is not clear that there is a need for a separate control objective for new/changed security recording if the reconciliation objective is an effective key control in identifying instances of improper security set-up.) **There is no specification as to which particular controls the qualified custodian may need to have, only the control objectives that the qualified custodian should meet. The qualified custodians have discretion how they meet those control objectives. The objectives need not literally be specified as stated in the guidance for accountants, so long as there was enough information in the internal control report that a user could see how the objectives were met.**
 - b. Does the use of the word "client" in the objectives relate to the adviser's client rather than the custodian's client (i.e., the adviser)?

The Guidance for Accountants specifies control objectives that need to be met in the qualified custodian's internal control report. Therefore, the objectives relate to the qualified custodian's clients, which include the adviser's clients.

Registrants or their auditors are encouraged to contact SEC staff on guidance pertaining to the specific facts and circumstances.

- c. Transition issues:
1. Some current SAS 70 reports may cover certain objectives but not in the explicit manner of the interpretation (for example, reconciliation of cash and securities between the custodian and depositories "completely, accurately and on a timely basis"). Particularly for large custodians having SAS 70 examinations on a semi-annual or annual basis, it may not be practicable to revise reports within the time frame contemplated by the release to explicitly address the objectives as stated. What procedures should advisers undertake in a transition period until reports can be modified to cover the explicit objectives specified in the interpretation? **As per the response to Question I.9 of the staff FAQ, a qualified custodian that obtained a custody-related SAS 70 report in 2009 is not expected to alter its reporting cycle in 2010 to meet (or allow its related person investment adviser to meet) the initial September 12, 2010 compliance date. However, the control objectives for the 2010 SAS 70 should address the control objectives specified in the Guidance for Accountants and the auditor must verify that funds and securities are reconciled to a custodian other than the adviser or its related person (e.g., DTC).**
 2. If the expectation is for issuance of an annual internal control report before performance of a surprise examination, in 2010 it is likely that most surprise examinations will take place in the second half of the calendar year. Going forward, it is also possible that surprise examinations will be concentrated in periods shortly after the issuance of controls reports to eliminate the need for updated controls testing. **The rule requires the surprise examination to be conducted at a time that is irregular from year to year. If the surprise examinations are concentrated in a certain time period each year, the "surprise" element of the requirement would not be met.**
- d. We noted that control objectives are not listed related to IT (e.g., logical security, program change control, computer operations). We believe that these would be essential to performance of an examination under either SAS 70 or AT 601. **The Guidance for Accountants established general**

control objectives and IT controls were not specifically identified as it likely is already utilized in meeting the specified control objectives.

Additionally, a question arose about situations where IT SAS 70 reports are separated from custody SAS 70 reports (for example, for IT outsourcing or where there is a single SAS 70 examination of a centralized data center handling multiple functions within a large financial services organization). The adviser should obtain all relevant SAS 70 reports that meet the identified control objectives.

- e. How should situations be handled where the adviser has outsourced "middle-office" functions (trade reconciliation function – it is a group that works between portfolio manager and custodian) to a third party but an internal control report for affiliated custody is still required? Would the internal control report requirement apply also to the "middle-office" outsourcer? **The adviser should obtain all relevant internal control reports required for it to meet identified control objectives.**
- f. For purposes of Form ADV reporting, in Schedule D, question 6 in Section 9.C. asks whether the internal controls report contains an "unqualified" opinion (a "yes/no" question). There are two questions related to a SAS 70 report:
 - 1. SAS 70 reports are "auditor-to-auditor" communications for purposes of financial statement audits. Accordingly, a "qualified" opinion in the qualified custodian's internal control report may be overcome by compensating controls at the user organization (i.e., the adviser), such that the combined control environment is effective. How should such a situation be handled in ADV reporting? **The respondent should still state that the report was qualified.**
 - 2. We are assuming that "qualification" means that the overall report on controls in operation contains an "adverse" or "except for" opinion. SAS 70 reports routinely report testing exceptions (e.g., 3 of 90 items selected were not in compliance) but the overall report is otherwise unqualified. **For testing exceptions that do not result in the qualification of the overall internal control report, the response should be that the internal control report was unqualified.**
- g. Will the distribution of the SAS 70/AT 601 reports be limited to the custodian, adviser and the SEC, or would they also be distributable to investors? It is reasonable to believe that, since the reports will be explicitly referred to in Form ADV, some clients or potential clients may ask to obtain or review them. **The report must be maintained by the**

adviser as part of its books and records. Distribution of the report to others is up to the adviser, its auditor and the adviser's clients.

3. For some multinational organizations, not only the main qualified custodian but some foreign subcustodians are related persons of an adviser. If a SAS 70/AT 601 report is required for the main qualified custodian, would similar reports be required for all foreign affiliated subcustodians holding client assets? **The internal control report is required to address the control objectives relative to the main qualified custodian. However, the auditor must verify that funds and securities are reconciled to an unaffiliated custodian.**
4. The companion interpretation permits the use of a sample of client accounts in the surprise examination. What level of sampling would the Commission consider *inadequate* to meet the requirements of the examination? **Sampling methodology chosen should be consistent with auditing literature. See 1c) above.**
5. The Commission requires the filing of a Form ADV-E within one day of the identification of a "material discrepancy" together with an "accountant's certificate". Almost by definition, the examination will not be complete when such a discrepancy is identified. What is the form of "accountant's certificate" contemplated by the Commission in this situation? **No certificate is required upon finding a material discrepancy; the certificate is required at the completion of the examination. The requirement is to *notify* the SEC within one business day of the finding of a material discrepancy.**
6. In some cases, certain pooled investment vehicles ("feeder" or "access" funds) hold only one investment in a non-affiliated fund. What obligation does the "feeder" fund have under the custody rule? **If an adviser is deemed to have custody of a "feeder" fund, an adviser must comply with custody rule.** Does the non-affiliated fund have any obligations? **Although it is unlikely that the adviser would have custody of the non-affiliated fund, if the adviser has custody of the assets of the feeder fund (e.g., has authority to withdraw feeder fund's investment from the underlying fund), the adviser would be subject to the rule.**
7. Under the revised rule, an adviser can treat an SPV either as a separate client or include the SPV's assets with the pooled vehicle(s) of which it has custody indirectly. Compliance with the custody rule would occur if the SPV's financial statements were distributed to investors in accordance with the audit provision (in the first option), or if the assets were subject to scope of the pooled vehicle's financial statement audit or surprise examination (in the second option). Would this be required regardless of the materiality of the assets in the SPV? In some cases, an SPV may not be material to any pooled vehicle and under GAAP and GAAS would not warrant separate reporting or significant audit procedures. **The SPV's assets should be subject to a**

sampling methodology permitted by the auditing literature. The pooled investment vehicle's financial statements should conform to GAAP.

8. Regarding changes in accountants, at what point, if any, should an accountant file a statement on Form ADV-E if they have simply not been engaged in the current year to perform required procedures (that is, there has been no affirmative resignation, dismissal, or replacement by a new accountant - just no execution of a written agreement for the current year)? **The accountant should file a statement on Form ADV-E once it has been informed by the RIA that it has not been engaged to perform a surprise exam. The adviser is obligated to ensure the SEC is informed when there is a change in accountants and the accountant generally should not make its own inferences in the absence of any communications about whether it has been dismissed; however, accounting firms are encouraged to communicate with the adviser if they have not heard from the adviser within a reasonable length of time.**

Also, while the actual filing of Form ADV-E (the form on which accountant changes will be reported) is the accountant's responsibility, the RIA has to give the accountant authority to file that form since the adviser, not the accountant, is the registrant under whose name it is filed.

9. Would an adviser need an internal control report if "self-custody" is only attributed through pooled vehicles subject to annual audit? If it is only attributed based on the ability to deduct fees? **An internal control report is required only if a RIA or its related person serves as a QC when the use of a QC is required by the rule. Also see footnotes 65 and 130 in the adopting release for further information.**
10. If an audit of a pooled investment vehicle is not completed within the 120/180 day time frame due to unexpected issues (e.g., inability by a fund-of-funds auditor to obtain necessary confirmations within 180 days; unanticipated qualification/scope limitation on an opinion), and the adviser is thus not in compliance with the surprise examination requirement for the prior year,
 - a. Would the existing SEC Q&A "reasonable belief" standard continue to apply? **The "reasonable belief" standard was retained in Question VI.9 of the SEC staff FAQ. If repeated instances of noncompliance occur each year, SEC staff examiners may have questions whether a "reasonable belief" existed.**
 - b. If not, what, if any, remedies are available to the adviser for alternative compliance regarding the prior fiscal year? **No remedies are available, as there can be no "retroactive compliance" with the rule. If the RIA was planning to satisfy the audit provision and determined it cannot, the RIA cannot retroactively cure it - not only would it need to have had a surprise exam, it would have had to comply with the notice and**

quarterly account statements requirements; also, for a pooled investment vehicle that invests in privately offered securities and cannot meet audit provision, those privately offered securities must be held by a qualified custodian. An adviser clearly cannot go back in time to meet those requirements. The fact that there are no remedies available is no different than prior to the amendments.

11. The revised rule permits maintenance of securities balances at a qualified custodian EITHER "in a separate account for each client..." OR "in accounts that contain only your clients' funds or securities...". The latter alternative seems to imply the use of omnibus accounting at the custodian with detail recordkeeping by the adviser by individual client. In that situation, it would not be possible for anyone other than the adviser to send quarterly statements to each client, since the custodian would not have visibility to holdings or activity by individual client. Would this mean that the adviser would be a) considered to have a form of self-custody and b) thus required to have a controls examination over its omnibus procedures and a surprise examination? **Having omnibus accounts alone would not cause an adviser to obtain an IC report because the omnibus accounts would not cause the adviser to be a qualified custodian. However, this arrangement may cause problems with compliance with other aspects of the rule such as the requirement for the qualified custodian to send account statements directly to clients.**

12. Offshore funds issues:

- a. The final release states that audited financial statements are to be "in accordance with generally accepted accounting principles" (presumably US GAAP). If an offshore fund issues financial statements under something other than US GAAP, would the financials be required to include a reconciliation to US GAAP for them to qualify under the alternative compliance rule? In particular, would "unreconciled" IFRS financial statements be acceptable?

Can other forms of GAAP be used in fund financial statements as long as those financials have substantially the same disclosure and accounting provisions as US GAAP financials (specifically referring to IFRS financial statements)?

Question VI.5 of the SEC staff FAQ addresses this issue. Advisers of offshore funds which are subject to the custody rule and elect to use the audit provision to satisfy the custody rule may meet the audit provision if the offshore funds' financial statements are prepared in accordance with accounting standards other than US GAAP as long as (1) the offshore fund's financial statements contain information substantially similar to financial statements prepared in accordance with US GAAP; (2) a reconciliation of any material differences between US GAAP and the accounting standards used by the offshore fund is included in financial statements distributed to U.S. persons;

and (3) the audit of the offshore fund's financial statements is performed in accordance with US GAAS.

- b. Some offshore jurisdictions require that funds registered in that jurisdiction submit financial statements with the audit report of an auditor located in that jurisdiction. In the case of a firm with operations in the US and that offshore jurisdiction, the firm located in the offshore jurisdiction may not issue reports on any "issuers" or play a "substantial role" in the audit of an issuer and thus would not be subject to regular inspection by the PCAOB⁴, even though the US affiliate does issue reports on "issuers" and is subject to regular inspection by the PCAOB. Most of the audit procedures are performed by the US affiliate and the local auditor places reliance on that work in issuing its report. Would the report of the local auditor not meet the requirement for an accountant that is registered with, and subject to regular inspection by, the PCAOB in those circumstances?

To meet the audit provision, the auditor must be registered with, and subject to regular inspection by, the PCAOB and the report must be distributed to the investors; otherwise, the report of the local auditor would not satisfy the custody rule requirement.

- c. Do custody requirements apply to US RIAs who advise offshore funds which only contain foreign investors? **The staff clarified this point in the August 10, 2006 no-action letter to the American Bar Association.⁵ – If the US RIA is registered with the SEC but has its principal office and place of business outside of the US, and if the pool the adviser provides services to is organized and incorporated outside the US, it does not matter whether foreign or domestic investors are in the pool - the pool is not subject to the custody rule. However, if the adviser's principal office and place of business is on US territory, then the pool would be subject to the custody rule, even if all the investors are non-US.**

13. Real estate issues:

- a. When a real estate fund is managed by a registered adviser, and owns real property (e.g., a building) through LP, GP, managing member or member interests in partnerships,

The answers would depend on whether an adviser provides advice with respect to the securities or real property.

1. Are those interests in partnerships considered "securities" subject to the custody rule? **An indirect interest in real property (e.g.,**

⁴ The meaning of "subject to regular inspection" is set forth in PCAOB Rule 4003.

⁵ See <http://sec.gov/divisions/investment/noaction/aba081006.pdf>

a limited partnership that invests in real property) could be a security and therefore could have an impact on whether the custody rule applies. However, this is a legal determination that depends on facts and circumstances.

2. Are cash and other securities held within those partnerships subject to the custody rule? **If any securities are being held, then the real estate fund would be subject to the custody rule; if all the assets in the partnership are cash and direct investment in real property, the partnership is not an advisory client and thus the adviser would not be subject to the custody rule with respect to the partnership.**
 3. Would the answer vary depending on the level of control the fund/advisor has over the partnership-like structure (i.e., GP/managing member would typically have control over cash and securities; limited partners may not have "custody" but could have substantive kick-out rights which could allow them to gain custody by replacing the GP/managing member)? **The rule relates to an adviser's control over assets. By definition, a limited partner would not be an active participant in management and therefore is unlikely to be an adviser that controls the partnership - therefore, the limited partner is most likely not subject to the rule.**
 4. If the cash/securities owned by the partnership are subject to the custody rule, would an internal control report be required for the controls over the partnership's cash/securities? **An internal control report is required only when a QC is required to hold the assets and the QC is the adviser or its related person.**
14. The amended rule says that the qualified custodians of pooled investment vehicles need to send out statements to the pool's investors. Do those statements need to contain detailed information on the individual holdings of the fund or are they meant to be account statements that detail activity of investor NAV/partner capital balances? **As per question VI.2 of the SEC staff FAQ, the statements should include funds and securities held by the pool and transactions entered into by the pool.**
15. The internal control report pertains to qualified custodians who custody related person registered investment adviser (RIA) client assets. As the Custody Rule generally exempts privately offered securities from the qualified custodian requirements established, one would then expect that RIAs or their related persons with custody of only privately offered securities and who are not Qualified Custodians would not have an Internal Control Report requirement – is this correct? In addition, if a related person Qualified Custodian also had custody of privately offered securities should the Internal

Control Report to cover the privately offered securities? **An internal control report is required only if the RIA or its related person is serving in the capacity of qualified custodian. If the RIA or its related person qualified custodian hold privately offered securities but are not holding such securities in the capacity of Qualified Custodian, no internal control report is required. Also see footnotes 65 and 130 in the adopting release for further information.**

Does the RIA to a Private Equity or Hedge Fund of Funds that is relying on the audit provision for such a fund and therefore does not need a qualified custodian to maintain privately offered securities require an internal control report because it maintains possession of private investments in underlying funds (e.g., subscription documents to the underlying funds)? **No, because such securities are not required to be held by a qualified custodian.**

16. Can a RIA hire a firm to perform a surprise examination after the fact to satisfy the custody rule? To clarify, if a RIA discovers in December of 2010 that it needed a count for FYE 2010, would it be able to hire an accounting firm to perform a count at any date during the 2010 calendar year in order to be in compliance with the custody rule? **This is also addressed in question/answer # 10, as the RIA may not have satisfied the notice and account statement requirements and if it was a pooled investment vehicle which holds privately offered securities and is not relying on the audit provision, such securities would have had to be held by a qualified custodian.**
17. Assuming the adviser cannot meet the “reasonable belief” standard set forth in the staff FAQ, if a fund cannot meet the 120-day distribution requirement and it engages an independent public accountant to conduct a surprise examination, would the adviser ever meet the custody rule’s requirements if the qualified custodian did not send account statements? **No, see discussion above.**
18. For what examinations under the Custody Rule must an accountant be registered with, and subject to regular inspection by, the PCAOB? **See Question II.8 of the SEC staff FAQ. An independent accountant registered with, and subject to regular inspection by, the PCAOB is required in the following three situations:**
- **Surprise exam where the adviser or its related person serves as the qualified custodian;**
 - **Internal control engagement - any time the IC report is issued, including when the adviser has determined that the adviser and its related person qualified custodian are operationally independent; and**
 - **Audit of a pooled investment vehicle to comply with the audit provision**

Note that registration alone is not sufficient and that the firm must also be subject to regular PCAOB inspection.

- 19. Liquidation Audit** - is the requirement for the financial statements at the date the plan is adopted or as of the date the final funds are distributed? What is reasonable timing for distribution? **For the purposes of the liquidation audit, the financial statements should be dated as of or near the final distribution date (generally, financial statements would not be distributed prior to the final fund distribution to investors).**

Note that an audit shall occur once every 12 months, therefore, for a fund with December 31, 2010 fiscal year-end, if the liquidation process started in October 2010 but was not completed until after year-end, an audit is still needed as of December 31, 2010, followed by a liquidation audit after the distribution has been completed. The rule indicates that the financial statements should be distributed promptly, which may be interpreted “as soon as reasonably possible.”

Question whether a single set of audited financial statements could be issued to cover the period from January 1, 2010 through the date of liquidation (exceeding 12 months) if the audited financial statements for that extended period could still be delivered to investors within the 120-day period required under the rule for the annual financials. **The audited financial statements can cover a period exceeding 12 months if they are delivered to investors within 120 days of the December 31, 2010 fiscal year-end and as long as the financial statements contained the following: 2 balance sheets - 1 balance sheet as of December 31, 2010 and 1 balance sheet as of the 2011 liquidation date and 2 income statements, 2 statements of changes in partners’ capital, and 2 statements of cash flows (if applicable), for the period from January 1, 2010 – December 31, 2010 and for the period from January 1, 2011 – 2011 liquidation date.**

- 20. Will the Staff update their FAQ on the Custody Rule? The staff initially updated the FAQ in March 2010 which is located at http://sec.gov/divisions/investment/custody_faq_030510.htm. The SEC staff will continue to update the FAQ as necessary.**
- 21. Should the Internal Control Report and Surprise Examination be conducted under US GAAS or PCAOB Standards? The internal control report and surprise examination should be conducted under US GAAS.**
- 22. The panel members also discussed some other matters, including:**
- Fee-only deductions – Is a registered investment adviser which has custody only as a result of its authority to deduct fees from client accounts

exempt from the Custody Rule if the qualified custodian sends out statements to the clients? **No.**

- Footnote 48 of the amended rule indicates that in order to perform an audit of a pooled investment vehicle to satisfy the audit provision, an independent public accountant must be registered with, and subject to regular inspection by, the PCAOB as of the commencement of the professional engagement period – would the fact the firm is hired subsequent to the beginning of the 2010 fiscal year preclude them for performing such engagement? **Question I.6 of the SEC staff FAQ indicates that the adviser can satisfy the requirement for exemption from the surprise examination if the accountant performing the audit of the pooled investment vehicle becomes subject to regular inspection by the PCAOB before the issuance of the audited financial statements for the pooled investment vehicle's 2010 fiscal year.**
- In a situation where a pooled investment vehicle does not rely on the audit provision exception (no audit) but the pool's qualified custodian will send quarterly account statements and the adviser will engage an accountant to perform a surprise examination – would the qualified custodian need to send statements to the limited partners? **Paragraph (a)(5) of Rule 206(4)-2 indicates that the quarterly account statements must be sent to the limited partners. As per question VI.2 of the SEC staff FAQ, the quarterly account statements need to include funds and securities held by the pool and transactions entered into by the pool.**